



Los Angeles County Office of Education

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Debra Duardo, M.S.W., Ed.D.
Superintendent

January 9, 2019

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Ms. Monica Garcia, Board President
Los Angeles Unified School District
333 South Beaudry Avenue, 24th Floor
Los Angeles, CA 90017-5141

Dear Ms. Garcia:

Under Education Code (EC) Section 42131, the Los Angeles County Superintendent of Schools (County Superintendent) has completed a review of the Los Angeles Unified School District's (District) 2018-19 First Interim Report. Our analysis of the data provided indicates that the District may not meet its financial obligations for the current or two subsequent years without implementing budget reductions and/or a Board-approved Fiscal Stabilization Plan (FSP) that restore and maintain the required minimum Reserve for Economic Uncertainties (REU) for 2020-21. While we concur with the District's qualified certification, our office is taking action under EC 42131(b) to assign a team of fiscal experts to the District.

In the previous Los Angeles County Office of Education (LACOE) letters, we have expressed great alarm and concern with the rapid deterioration of the District's fund balance and reserve levels. We have also expressed concerns with the District using one-time funding to cover ongoing expenditures absent a strong plan to balance the budget. LACOE's letters have also directed the District to develop a Fiscal Stabilization Plan that will address the projected deficit spending. In review of the First Interim and the FSP, we continue to be alarmed that the Governing Board has failed to present a financial report that maintains the minimum 1% reserve level in the current plus two subsequent years as required by law.

Because your projections indicate a 90.62% drop in reserve levels over a three-year period without an adequate plan to address the significant deficit spending, the District continues to demonstrate serious signs of fiscal distress that cannot be ignored. Our concerns are in alignment with the Fiscal Crisis and Management Assistance Team's (FCMAT) Indicators of Risk of Potential Insolvency. The areas of most concern are:

- Inability to consider long-term impacts of collective bargaining agreements;
- Staff unrest and/or low morale;
- Lack of a long-range facilities plan;
- Deficit spending and failure to maintain adequate reserves and fund balance;

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- Lack of control and monitoring of total compensation as a percentage of total expenses; and
- Inattention to unfunded liabilities [OPEB].

Due to the distressed fiscal condition of the District, EC 42131(b) allows the County Superintendent to intervene and compel the District to implement certain measures or combination of measures to improve the fiscal condition of the District.

Effective immediately, I am assigning a fiscal expert team to the District. Dr. Jim Morris will lead the team's efforts within the District. Dr. Morris will report back to me and the LACOE Chief Financial Officer, Dr. Candi Clark, on the progress of the District. It is our expectation that the Governing Board will work with the LACOE fiscal expert team to implement any and all actions necessary to stabilize the fiscal condition of the District. LACOE will continue to look to the Governing Board to take a strong leadership role in resolving the District's fiscal challenges and do what is in the best interest of the students that you serve.

BACKGROUND

In our letter dated November 8, 2018, the District's Governing Board was required to do the following no later than December 17, 2018:

- Address deficit spending in an updated FSP with Board Resolution;
- Make any necessary Board-approved adjustments to the 2018-19 budget, and adopt an updated, detailed FSP with Board Resolution;
- Continue to allocate any potential expenditure reductions to the appropriate account codes in the multi-year projection, instead of as a lump-sum amount;
- Any reductions that require negotiation with the District's bargaining units should be included only if those negotiations have been settled. Revenue enhancements that require approval by the District's voters, such as a parcel tax, cannot be considered until voter approval is obtained;
- Continue to monitor all Fiscally Independent Charter Schools (FICS), facilitate resolution of 2018-19 projected negative ending net positions, and submit First Interim Reports for each FICS, in either SACS form or an alternate form. Written status reports on the 15 FICS and any new FICS with negative ending net position, should be submitted subsequently; and
- Board-approve and submit the 2018-19 First Interim Report to the County Superintendent.

As required, the District submitted its General Fund 2018-19 First Interim Report, including an updated FSP and Board resolution. However, the Governing Board failed to adequately address its structural imbalance of deficit spending. As a result, the District filed a qualified budget certification. Any combination of enhanced revenues, reduced expenditures, or release of assigned

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ending fund balance would have allowed the District to meet the 1.00 percent minimum requirement per State Criteria and Standards.

FISCAL STABILIZATION PLAN

We noted in our review that the District's updated FSP includes the following reductions:

- \$42.9 million, or approximately 15 percent, for Central Office Reduction;
- \$5.0 million for Change in Procurement Cycle for uniforms;
- \$3.0 million for Attendance Incentive Program additional allocation discontinuance; and
- \$2.1 million for additional Central Office Reduction.

With this updated FSP, the Governing Board accepted the \$35.0 million for Administrator to Teacher Ratio (R2) penalties in 2019-20 and 2020-21 by assigning this amount in the ending fund balance. However, the Governing Board chose not to implement the previously identified reductions of \$6.0 million for Freeze on Travel, Cellphone and Equipment, and \$29.0 million, or approximately another 10 percent, for Central Office Reduction.

DEFICIT SPENDING AND RESERVES

The District is projecting an operating surplus of \$113.3 million, representing 2.39 percent of the unrestricted General Fund's projected expenditures and other outgo for fiscal year 2018-19. The District then projects worsened operating deficits of \$201.9 million and \$176.5 million, representing 4.18 percent and 3.73 percent, for fiscal years 2019-20 and 2020-21, respectively. According to our review of the District's First Interim Report data and assumptions, and as confirmed by the District, the projected deficits are primarily due to revenue loss associated with declining enrollment, the increasing costs related to pensions, Special Education encroachment and facilities maintenance required minimum contribution.

The District's unrestricted General Fund ending balance and reserves are projected to decrease as a result of deficit spending, which is illustrated in the table below.

Unrestricted General Fund Projection

(\$ millions)	<u>2018-19</u>	<u>2019-20</u>	<u>2020-21</u>
Beginning Unrestricted General Fund Balance	\$1,863.2	\$1,976.5	\$1,774.6
Projected Deficit Spending	\$113.3	(\$201.9)	(\$176.5)
Ending Unrestricted General Fund Balance	<u>\$1,976.5</u>	<u>\$1,774.6</u>	<u>\$1,598.1</u>
Nonspendable	(\$27.6)	(\$27.6)	(\$27.6)
Commitments to Settlements	(\$174.6)	(\$87.6)	(\$0.0)
Assignments per Board	(\$1,019.3)	(\$1,230.2)	(\$1,499.7)
Reserve Amount	\$755.0	\$429.3	\$70.8
Reserve Percent	10.22%	5.71%	0.96%

We continue to be alarmed that the Governing Board is failing to recognize the long-term impact of the District's structural deficit spending and remain concerned that time-sensitive financial decisions are being postponed. Over the multi-year span, the unrestricted General Fund's reserve is projected to decrease from \$755.0 million to \$70.8 million, a decline of 90.62 percent. The deficit spending in 2019-20 and 2020-21 depletes reserves to below the State Criteria and Standards 1.00 percent required level in 2020-21. Therefore, we require that the District work with the LACOE fiscal expert team to address deficit spending in an updated FSP with Board Resolution to be submitted with its 2018-19 Second Interim Report, due to our office on or before March 18, 2019. As in prior letters, our recommendation is to seek ways to balance the budget through expenditure reductions, revenue enhancements, or a combination of the two.

RESERVE FOR ECONOMIC UNCERTAINTIES (REU)

The District's First Interim Report projects an REU of 10.22 percent for 2018-19, 5.71 percent for 2019-20, and 0.96 percent for 2020-21. Due to the District continuing to operate at the current projected deficit spending levels, the unrestricted General Fund ending balance and REU will be exhausted by the end of 2020-21. The year-to-year cumulative effects of reclassifying committed or assigned ending fund balances to salaries and employee benefits as labor settlements are reached

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results in increased expenditures and decreased reserve amounts. The First Interim Report that was approved by the Governing Board included a \$17.2 million increase in other assignments in 2020-21 when compared to the assignments included in the Revised Budget for the same year.

The District is required to update its FSP and include the necessary Board-approved adjustments to the 2018-19 budget and multi-year projections to ensure that the ending fund balances and REUs are restored and maintained at the required level.

DECLINING ENROLLMENT AND REDUCED STATE FUNDING

The District's 2018-19 First Interim Report reflects declining enrollment from traditional schools and locally funded/affiliated charter schools with projected funded average daily attendance (ADA) of 471,450 for 2018-19, 458,936 for 2019-20, and 444,566 for 2020-21. The estimated impact of the declining enrollment on the District's projected funded ADA reflects a two-year loss totaling 26,884 ADA, representing a 5.70 percent decrease from the District's 2018-19 ADA. This rate of decline in enrollment, if continued as projected, represents a loss of revenue for the District in the current and future years. As previously recommended, the District must continue to assess and take immediate steps to adjust its staffing needs and develop a plan to optimize facility utilization given the projected ongoing decline in enrollment.

Declining enrollment districts with charter schools must also consider the effect of the movement of district ADA to district-authorized charter schools. ADA for students who attended a district non-charter the previous year, and who now attend a district-authorized charter, is deducted from prior year ADA for purposes of calculating declining enrollment ADA.

LABOR CONTRACT NEGOTIATIONS

According to the information provided in the District's First Interim Report, except for the comprehensive Health Benefits Agreement, Service Employees International Union, Associated Administrators Los Angeles, California School Employees Association, Teamsters, and District-represented settlements, the certificated union's and three classified unions' labor contract negotiations for 2017-18 and 2018-19 remain unsettled. However, potential increases have been calculated and incorporated into budgeted salary and benefit assignments of ending fund balance. Because labor costs make up a large portion of the District's budget, we remain concerned that any salary and benefit increase, if paid from reserves or other one-time resources, could adversely affect the financial condition of the District. We continue to caution the District that this approach of funding ongoing salary increases with one-time resources is not a best business practice.

This letter is a reminder, before the District's Governing Board takes any action on a proposed collective bargaining agreement, the District must meet the public disclosure requirements of Government Code Section 3547.5 and the California Code of Regulations Title V, Section 15449.

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The document used for this analysis was included in Informational Bulletin No. 4845, dated July 2, 2018, and is titled “2018-19 Forms for Assembly Bill (AB) 1200: Public Disclosure of Proposed Collective Bargaining Agreements.” This document can be found at the following website:

<https://www.lacoe.edu/BusinessServices/DocumentsForms.aspx>

In addition, pursuant to Government Code Section 3540.2(a), a school district with a qualified or negative certification must allow the County Office at least 10 working days to review and comment on any proposed agreement between the exclusive representative and the public school employer before it is ratified.

DEBT ISSUANCE

This letter also serves as a reminder of the statutory requirements placed on debt issuance by school districts with qualified or negative interim report certifications. These requirements are specifically addressed by EC Section 42133 (a).

COUNTY OFFICE ANNUAL REPORT

Pursuant to the provisions of EC Section 1240(e), the County Superintendent is required to present an annual report to a school district’s governing board and to the Superintendent of Public Instruction regarding the fiscal solvency of any school district with a disapproved budget, qualified or negative interim certification during the current fiscal year. This County Office report will be issued to the District in June 2019.

FISCALLY INDEPENDENT CHARTER SCHOOLS OVERSIGHT

Authorizing districts are required, by EC Section 47604.32, to ensure each charter school under its authority complies with all reports required by law of charter schools, and to monitor the fiscal solvency of that charter school. Furthermore, EC Section 47604(c) specifies failure to comply with all oversight responsibility could result in a district losing its protection against liability for any nonprofit public benefit corporation charter school that the district has authorized.

Therefore, it is critical that charter schools’ budgets and Interim Reports contain sufficient fiscal information to enable their authorizing districts to perform adequate review and analysis of the report as part of their fiscal oversight responsibilities. As part of this oversight responsibility, authorizers should request a rationale for all negative fund balances, for which the district would be held liable. Authorizing districts are urged to collect supporting data, in addition to the budget, from their charter schools similar to what districts submit to LACOE, including detailed assumptions and multi-year projections.

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Effective 2018-19, the District's Charter School Division no longer consolidates and reports the direct-funded charter schools' budgeted revenues and expenditures under SACS Form 09 (Charter Schools Special Revenue Fund) and SACS Form 62 (Charter Schools Enterprise Fund). These FICS complete and report the SACS forms directly to the District for routing to LACOE.

The District routed its 220+ FICS SACS Form 62 for 2018-19 July 1 Budget with 12 FICS having a 2018-19 negative ending net position totaling \$20.9 million. Subsequently, the District's 2017-18 Unaudited Actuals were submitted with 15 FICS having a 2017-18 negative ending net position totaling \$26.9 million. The District is required to continue to monitor all FICS, facilitate resolution of 2018-19 projected negative ending net positions, and submit 2018-19 Second Interim Reports for each FICS, in either SACS form or an alternate form. Written status reports on the 15 FICS and any new FICS with negative ending net position, should be submitted subsequently.

SUBMISSION OF STUDIES, REPORTS, EVALUATIONS, AND/OR AUDITS

EC Sections 42127 and 42127.6 require districts to submit to the County Superintendent any studies, reports, evaluations, or audits completed of the district that contain evidence that the district is showing fiscal distress. They also require the County Superintendent to incorporate that information into our analysis of budgets, interim reports, and the district's overall financial condition.

We remind the District to submit any such documents to this office that are commissioned by the District (e.g., reports completed by the Fiscal Crisis and Management Assistance Team), or by the State Superintendent of Public Instruction, and/or a State control agency, and an internal audit division any time they are received by the District.

We have obtained the District's Projected Financial Position Analysis, dated September 26, 2018, prepared by Houlihan Lokey Financial Advisors, Inc. We are also in receipt of the District's most recent fact finding report as it relates to negotiations with United Teachers Los Angeles.

DISTRICT FOLLOW-UP REQUIREMENTS

Because the District filed a qualified First Interim Report certification, the District's Governing Board is required to do the following for its 2018-19 Second Interim Report, due to our office on or before March 18, 2019.

- Work with the LACOE fiscal expert team;
- Address deficit spending in an updated FSP with Board Resolution restoring the minimum reserve requirements;
- Make any necessary Board-approved adjustments to the 2018-19 budget, and adopt an updated, detailed FSP with Board Resolution;

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- Continue to allocate any potential expenditure reductions to the appropriate account codes in its multi-year projections, instead of as a lump-sum amount;
- Any reductions that require negotiation with the District's bargaining units should be included only if those negotiations have been settled. Revenue enhancements that require approval by the District's voters, such as a parcel tax, cannot be considered until voter approval is obtained;
- Continue to monitor all FICS, facilitate resolution of 2018-19 projected negative ending net positions, and submit Second Interim Reports for each FICS, in either SACS form or an alternate form. Written status reports on the 15 FICS and any new FICS with negative ending net position, should be submitted subsequently; and
- Board-approve and submit the 2018-19 Second Interim Report to the County Superintendent.

The above requirements, particularly the multi-year projections without unallocated expenditure reductions, and FSP with Board Resolution, will be crucial factors in our review and certification concurrence with the District's 2018-19 Second Interim Report, due to the County Superintendent no later than March 18, 2019.

CONCLUSION

The Governing Board is ultimately responsible for ensuring that all local decisions support and promote the fiscal health of the District. The LACOE fiscal expert team will work closely with the District's Governing Board, Administration and staff to monitor the District's commitment to fiscal solvency. If you have questions regarding your District's qualified interim, please call Dr. Candi Clark at (562) 922-6124 or Keith Crafton at (562) 922-6131.

Sincerely,



Debra Duendo, M.S.W., Ed.D
Superintendent

CC/KDC/TSS:rc

cc: Austin Beutner, Superintendent, Los Angeles Unified School District (LAUSD)
Scott S. Price, Ph.D, Chief Financial Officer, LAUSD
Pedro Salcido, Director, Finance Policy, LAUSD
Cheryl Simpson, Director, Budget Services and Financial Planning, LAUSD
David Holmquist, Esq., General Counsel, LAUSD
José J. Cole-Gutiérrez, Director, Charter Schools Division, LAUSD
Robert Samples, Interim Director, Office of Labor Relations, LAUSD
Jose R. Cantu, Ed.D., Assistant Chief Human Resources Officer, LAUSD

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Karla Gould, Personnel Director, LAUSD
V. Luis Buendia, Controller, Accounting and Disbursements Division, LAUSD
Joy Mayor, Deputy Controller, Accounting and Disbursements Division, LAUSD
Margaret Lam, Deputy Budget Director, LAUSD
Victoria Reyes, Assistant Budget Director, LAUSD
Tony Thurmond, State Superintendent of Public Instruction
Lupita Cortez Alcalá, Chief Deputy Superintendent of Public Instruction
Caryn Moore, California Department of Education
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